

# NAR Frequently Asked Questions Health Insurance Reform



National Association of REALTORS® Government Affairs Division  
500 New Jersey Avenue, NW, Washington DC, 20001

## NEW MEDICARE TAX ON “UNEARNED” NET INVESTMENT INCOME

### Q-1: Who will be subject to the new taxes imposed in the health legislation?

**A:** A new 3.8% tax will apply to the “unearned” income of “High Income” taxpayers. Another 0.9% tax will apply to the “earned” income of many of these same individuals. Both levies are referred to as “Medicare” taxes. (For a description of the new 0.9% tax, see separate Q&A entitled “NEW TAX ON EARNED INCOME: WAGES, SALARIES AND COMMISSIONS.”)

### Q-2: Who is a “High Income” Taxpayer?

**A:** Those whose tax filing status is “single” will be subject to the new unearned income taxes if they have Adjusted Gross Income (AGI) of more than \$200,000. Married couples filing a joint return with AGI of more than \$250,000 will also be subject to the new tax. (The AGI threshold for married filing separate returns is \$125,000.)

### Q-3: Are the \$200,000 and \$250,000 thresholds indexed for inflation?

**A: No.** Thus, over time, more individuals may become subject to this tax.

### Q-4: When does the new 3.8% Medicare tax take effect?

**A:** The new Medicare tax on unearned income will take effect January 1, 2013.

### Q-5: What is “unearned” net investment income?

**A:** Unearned income is the income that an individual derives from investing his/her capital. It includes capital gains, rents, dividends and interest income. It also comes from some investments in active businesses *if* the investor is not an active participant in the business.

The portion of unearned income that is subject both to income tax and the new Medicare tax is the amount of income derived from these sources, *reduced* by any expenses associated with earning that income. (Hence the term “net” investment income.) Thus, in the case of rents, the taxable amount would be gross rents minus all expenses (including depreciation) incurred in operating the rental property. So if gross rents were \$100,000 with associated expenses of \$40,000, net rents of \$60,000 (\$100,000 minus \$40,000) would be included in Adjusted Gross Income (AGI).



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## Q-6: So the new tax will apply to rents from investment properties that I own?

**A: Maybe.** Remember that net investment income includes only *net* rental income. Thus, gross rents would not be subject to the tax. Rather, gross rents would be reduced (as they are under the income tax) by all allowable expenses, including depreciation, cost of repairs, property taxes and all other expenses related to the property. AGI includes net income from rent, so if your AGI is above the \$200,000/\$250,000 thresholds, then the rental income might be subject to the tax. For many investment real estate owners, the net rents will be the same as or similar to the amounts reported on their Schedule E, filed with their Form 1040 Income Tax Return. (For calculations, see Q-8, below. See also Q-9 through Q-12 related to capital gain from sale of principal residence, losses on sale and to vacation homes, below.)

## Q-7: Does the tax apply to the yearly appreciation of an asset?

**A: No.** *Capital gains are subject to this new tax only in the year when the asset is sold.* The amount of the gain will be measured in the same way that it is for income tax purposes. This rule applies to real estate and all other appreciating capital assets. Net capital gains are taxable only in the year of sale.

## Q-8: How is the new 3.8% Medicare tax calculated?

**A:** The new 3.8% Medicare tax is assessed *only* when Adjusted Gross Income (AGI) is more than \$200,000/\$250,000. (See Q-2 above.) AGI includes net income from interest, dividends, rents and capital gains, as well as earned compensation and several additional forms of income presented on a Form 1040 Income Tax Return.

*The tax is NOT imposed on the total AGI, nor is it imposed solely on the investment income.* Rather, the taxable amount will depend on the operation of a formula. The taxpayer will determine the **LESSER** of (1) net investment income **OR** (2) the excess of AGI over the \$200,000/\$250,000 AGI thresholds. Thus, if net investment income is the smaller amount, then the 3.8% tax is applied *only* to the net investment income amount. If the excess over the thresholds is the smaller amount, then the 3.8% tax would apply *only* to the excess amount.

For example, if AGI for a single individual is \$275,000, then the excess over \$200,000 would be \$75,000 (\$275,000 minus \$200,000). Assume that this individual's net investment income is \$60,000. The new 3.8% tax applies to the smaller amount. In this example, \$60,000 of net investment income is less than the \$75,000 excess over the threshold. Thus, in this example, the 3.8% tax is applied to the \$60,000.

If this single individual had AGI of \$275,000 and net investment income of \$90,000, then the new tax would be imposed on the smaller amount: the \$75,000 of excess over \$200,000.





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Rules of thumb for predicting the application of this tax year to year are not readily determinable, largely because the proportion of net investment income compared to AGI will vary from year to year and from individual to individual.

## **Q-9: Will the \$250,000/\$500,000 exclusion on the sale of a principal residence continue to apply?**

**A: Yes.** Any gain from the sale of a principal residence that is less than \$250,000 (individual) or \$500,000 (joint return) will continue to be excluded from the income tax. The new 3.8% tax will **NOT** apply to this excluded amount of the gain.

## **Q-10: Will the 3.8% tax apply to any part of the gain on the sale of a principal residence?**

**A:** The new Medicare tax would apply only to any gain realized that is more than the \$250K/\$500K existing primary home exclusion (known as the “taxable gain”), and only if the seller has AGI above the \$200K/\$250K AGI thresholds.

So, for example, if the taxable gain was \$30,000 and a married couple had AGI (which would include the taxable gain) of \$180,000, the 3.8% tax would *not* apply because AGI is less than \$250,000. If that same couple had AGI of \$290,000, then the application of the 3.8% tax would be subject to the same formula described above. The \$30,000 taxable gain on the sale would be less than the \$40,000 excess above \$250,000 AGI, so the \$30,000 gain would be subject to the new 3.8% tax.

## **Q-11: Is rent from a vacation home subject to the 3.8% tax? And what about the gain on sale of a vacation or rental property?**

**A:** The application of the tax will depend on whether the vacation home has been rented out, the period for which it has been rented and whether the property is solely for the enjoyment of the owner. If the owner has rented the home out to others, then the 14-day rent exclusion will continue to apply. Thus, if the owner rents the property to others (including family members) for 14 or fewer days, there would be no net investment tax. (Note that no deductions for expenses would be available, as under current law.)

If the home has been rented to others (including family members) for more than 14 days, then the rents (minus related expenses) would be considered as part of net investment income and could, depending on AGI and the calculations described above, be subject to the new tax.

If the vacation home has been used solely for personal enjoyment (i.e., there is no rental income and no associated expenses), then a gain on sale would be treated as net investment income and could be subject to the tax, depending on AGI. Similarly, if the property had generated rents, any net gain on sale could also be included in net investment income. The amount of the tax (if any) would depend on the calculation formula, above in Q-8.

